BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA

DOCKET NO. 2023-388-E

In the Matter of:	)	
	)	**DIRECT TESTIMONY OF**
Application of Duke Energy Carolinas, LLC	)	**SEAN P. RILEY**
For Authority to Adjust and Increase its	)	**FOR DUKE ENERGY**
Electric Rates and Charges	)	**CAROLINAS, LLC**

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Sean P. Riley. My business address is PricewaterhouseCoopers LLP, 101 Seaport Boulevard, Boston, Massachusetts 02210.

Q. ON WHOSE BEHALF ARE YOU SUBMITTING THIS DIRECT TESTIMONY?

A. I am submitting this direct testimony on behalf of Duke Energy Carolinas, LLC ("DEC" or the "Company").[1]

Q. PLEASE DESCRIBE YOUR OCCUPATION AND WORK EXPERIENCE.

A. I graduated from the University of Vermont in 1990 and was hired by Coopers & Lybrand (predecessor company to PricewaterhouseCoopers LLP ("PwC")) in 1992 as an auditor focused on the financial statement audits of regulated utilities. PwC is the largest professional services network in the world, providing audit, tax, and advisory services to the largest and most complex companies globally. I was admitted to the partnership of PwC in 2004. I am a certified public accountant ("CPA") currently licensed in Maine and Massachusetts.

I am a member of PwC's National Energy, Utility and Resources ("Utility") practice. Our nationally recognized practice is viewed as a leader in

[1] This testimony was prepared by Sean P. Riley in connection with the current DEC rate case and for the use and benefit of DEC. PricewaterhouseCoopers LLP disclaims any contractual or other responsibility to others based on their access to or use of this direct testimony and the information contained herein.

the utilities sector, and comprises over 1,300 professionals, including professionals experienced in serving rate-regulated entities. We serve all of the largest and most complex regulated utilities in the United States.

I currently have two roles within our Utility practice. First, I am an Assurance Partner leading significant financial statement and internal controls over financial reporting audit engagements in the utility sector. In addition, I lead PwC's Complex Accounting and Regulatory Solutions ("CARS") practice. In this role, I oversee a team of highly experienced utility sector specialists that advise clients on complex technical accounting and regulatory/ratemaking matters.

I previously completed a three-year tour as the Utility and Renewable Energy technical accounting leader in the Accounting Services Group within PwC's National Office. I have been a frequent speaker at PwC utility industry events, as well as for organizations such as the Edison Electric Institute ("EEI") and American Gas Association ("AGA").

Q. HAVE YOU DEALT WITH THE UNIQUE ACCOUNTING AND FINANCIAL REPORTING ISSUES ENCOUNTERED BY REGULATED ENTERPRISES?

A. Yes. Throughout my career, I have focused on utility accounting and regulatory/ratemaking issues, primarily as a result of auditing and advising regulated enterprises. The unique, generally accepted accounting principles ("GAAP") applicable to regulated entities embodied in Accounting Standard Codification ("ASC") 980 *Regulated Operations* ("ASC 980") (previously

known as Statement of Financial Accounting Standard ("SFAS") 71, *Accounting for the Effects of Certain Types of Regulation* ("SFAS 71")) and related standards all need to be understood so that auditors can determine if a company's accounting has been applied appropriately. It is also necessary to have a solid understanding of the concepts of ratemaking (i.e., how rates are established for various classes of ratepayers and how utilities are paid for the services they provide) for regulated utilities in order to ensure that a company's accounting is in accordance with GAAP. During my career, I have consulted with utilities, and internally with other PwC engagement teams, as to how these ratemaking concepts and related accounting standards should be applied.

Q. HAVE YOU PROVIDED TRAINING ON THE APPLICATION OF GAAP TO REGULATED ENTERPRISES?

A. Yes. I have developed and presented utility accounting seminars focusing on the unique aspects of the regulatory process and the resulting accounting consequences of the application of GAAP. I have presented at seminars as well as delivered training on an in-house basis.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS OR ANY OTHER COMMISSION?

A. I have not presented live testimony before the Public Service Commission of South Carolina (the "Commission"); however, I did submit pre-filed direct and rebuttal testimony in Duke Energy Progress, LLC's ("DEP") most recent South Carolina rate case in Docket No. 2022-254-E. I also testified in DEC's 2019 North Carolina rate case in Docket No. E-7, Sub 1214, and DEP's 2019 North

Carolina rate case in Docket No. E-2, Sub 1219. I have also provided testimony across the United States, including Hawaii. Missouri and Massachusetts, as well as various matters before the Federal Energy Regulatory Commission ("FERC").

Q. PLEASE DESCRIBE THE PURPOSE OF YOUR TESTIMONY.

A. My testimony will address GAAP applicable to rate-regulated activities and the concept of deferral accounting, including the recovery of deferred costs through the ratemaking process. Specifically, I will address the appropriateness of recovering both (1) the deferred cost itself and, in many cases, (2) a return on the unamortized balance of the deferred cost when recovery occurs over an extended period.

Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR TESTIMONY.

A. When utility investors supply the funding for expenditures prior to recovery from customers, a return is generally permitted on such a regulatory asset until recovery has occurred. In other words, investors receive both a "recovery of" and a "return on" their investment. Recovery of the investment means the investor receives full cost recovery of each dollar invested. In addition, the investor would typically receive a return on its investment until the balance has been recovered. In this manner, the investor is made whole for its investment.

To the extent that a utility incurs a cost of providing service that is unanticipated or at a level that was not recovered in existing rates, it must utilize its own funds (provided by investors) to pay for such costs. Typically, operations and maintenance ("O&M") costs that are considered recoverable

from ratepayers are recovered quickly (i.e., in the short-term (within a year)), as it is the current ratepayers that benefitted from such expenditures/service. If, however, recovery of these costs is deferred to the future (beyond a year), customers are essentially receiving a loan from the utility since, by definition, these costs are not being recovered in current rates, and the customers will instead pay for the utility's expenditure over a period of time rather than at the point the utility incurs the expenses. As a result, cost deferrals should receive a carrying charge (i.e., a return) to compensate a utility investor for the use of capital.

Cost deferrals are treated in a similar manner as invested capital for ratemaking purposes. In other words, it is appropriate to recover a return on all deferred costs regardless of whether the underlying costs are capital or without the deferral would have been operating expenses in nature. In both cases, utility investors are providing the funds in advance and the utility is only recovering the costs from customers over time. The utility must compensate its investors for the time value of money through financing costs in the meantime. Not allowing a utility to recover financing costs from its customers would both prevent the utility from recovering prudently incurred costs and would also compromise the utility's ability to attract and secure capital.

Q. DOES YOUR TESTIMONY INCLUDE ANY EXHIBITS?

A. Yes. Riley Exhibit 1 includes my educational and professional background.

II. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES APPLICABLE TO RATE-REGULATED ENTITIES

Q. CAN YOU PROVIDE BACKGROUND ON THE APPLICATION OF GAAP TO RATE-REGULATED ENTITIES SUCH AS DEC?

A. Yes. GAAP provides the framework for measuring and reporting assets, liabilities, revenues, and expenses in financial statements. Such principles present a "common yardstick" for investors and others who are interested in the financial condition and results of operations so that investors can evaluate the entity, for among other things, potential investment. The Financial Accounting Standards Board ("FASB") and its predecessors promulgate accounting principles for various transactions. Periodic reporting of results under GAAP for publicly traded entities occurs through Annual Reports to investors and other stakeholders (for example, state and federal regulators, including the United States Securities and Exchange Commission, the agency responsible for protecting investors). While GAAP presents a common yardstick for accounting and reporting, there are certain industries where GAAP takes into account the unique nature of such industries so that the appropriate financial results are presented in a way that reflects the differing economic consequences of that industry.

Q. DOES RATE REGULATION CREATE UNIQUE ECONOMIC CONSEQUENCES THAT NEED TO BE CONSIDERED WHEN PRESENTING FINANCIAL RESULTS UNDER GAAP?

A. Yes. Under traditional rate regulation for investor-owned utilities, the prices charged for services provided by utilities (electric, gas and water entities) are

regulated (subject to review and approval) by a state's regulatory commission or FERC, as applicable. This is because such entities provide a necessary service and operate as natural monopolies. Without such regulation, the monopoly utility could potentially earn "super-monopoly" profits. Instead, the regulatory compact requires the utility to serve all customers in a specific service territory and, in return, the regulatory commission regulates various aspects of the utility, including pricing.

The prices charged by a rate-regulated utility are based on the utility's cost of providing service, including both capital and operating costs. Capital costs include a return on investment to utility investors measured as the allowed rate base times an allowed rate of return. Operating costs include necessary O&M expenses, depreciation, and taxes, among others. A general rate case is the vehicle in which a regulated utility presents their costs to a regulator for review and approval of recovery from customers. In a general rate case, the sum of a utility's operating and capital costs is referred to as the "revenue requirement."

Q. HOW DOES RATE REGULATION IMPACT GAAP?

A. In the ratemaking process, the regulator may decide to permit recovery of a prudently incurred cost in a period different from when GAAP would require such cost to be reported. For enterprises in general, there is no direct link between expenses and revenues (i.e., revenues, and therefore prices charged for products or services, are based on what the market will bear). Because rate-regulated utilities operate as monopolies and are not subject to normal market

competition, the regulator acts as a substitute for competition and requires periodic rate adjustment cases for the utility to present its costs for the development of its revenue requirement. Under this unique rate-regulation mechanism, the revenues that can be charged by a utility are based on its costs. There is a link between revenues and costs (i.e., a matching) that should be reflected in the utility's financial statements. This linkage provides guidance to the unique accounting followed by rate-regulated utilities as contained in ASC 980, which includes the concepts initially included in SFAS 71.

Q. WHAT IS ASC 980 AND ITS PREDECESSOR STATEMENT SFAS 71?

A. SFAS 71 was issued by the FASB in 1982. This Statement was the primary accounting principle providing accounting guidance for rate-regulated entities. It addressed the unique accounting for entities where a clear linkage exists between rates or tariffs charged to customers and a rate-regulated company's costs. A rate-regulated enterprise's costs include both necessary operating expenses and an allowed return (representing the cost of capital, both debt and equity).

Under SFAS 71, utilities are required to defer, as regulatory assets, incurred costs that non-regulated entities would charge to expense if, as a result of the regulatory process, it is probable that such costs will be recovered in future periods from charges to ratepayers. In this manner, the matching of reported costs and revenues is accomplished. If SFAS 71 did not exist, the utility would record revenues and costs in the period incurred even though the revenues in the period may be based on costs that may have been incurred in a

previous period. Such accounting would not reflect the economic effects of rate regulation. Additionally, rate-regulated entities are required to record regulatory liabilities when it becomes probable that a regulator will require the refund of revenues previously charged to and collected from ratepayers, or when amounts are collected in advance of a cost being incurred. Under SFAS 71, the accounting follows (matches) the ratemaking, not the other way around. The FASB codified the concepts of SFAS 71 within ASC 980 in September 2009.

Q. WHAT ARE THE REQUIREMENTS FOR APPLYING ASC 980?

A. ASC 980-10-15-2 provides the specific scope requirements of ASC 980. Entities with regulated operations that meet all of the following criteria are required to apply ASC 980 to the general purpose external financial statements of its regulated operations:

> *a. The entity's rates for regulated services or products provided to its ratepayers are established by, or are subject to, approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.*
>
> *b. The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products ...*
>
> *c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs ...*

Q. GENERALLY, WHICH TYPES OF ENTITIES FOLLOW THE ACCOUNTING UNDER ASC 980?

A. Historically, rate-regulated electric, gas and water utilities follow the accounting requirements of ASC 980. Unlike competitive entities, where the rates (prices) charged for products or services are based on competition, rate-regulated entities typically set the rates they charge their customers based on their costs, as determined in a rate case in which test year operating and capital costs are presented to a regulator, with a revenue requirement based on costs ultimately ordered. Utilities typically have exclusive right to and are required to provide service in their authorized jurisdiction in exchange for oversight by the applicable state commission of a number of operational and financial factors, such as determining the rates that can be charged to customers. The economic effects of regulation were considered unique by the FASB when they considered the accounting that eventually resulted in ASC 980.

To reiterate this point, because rate-regulated utilities are permitted to charge rates (revenue) based on costs, their financial statements should recognize the direct linkage between costs and revenues. Further, if a regulator permits recovery (revenue) of a cost subsequent to an accounting period when the actual cost was incurred, that cost should be deferred on the balance sheet (rather than expensed in the income statement) and amortized to the income statement in the period in which the revenues to recover that cost are being reflected. This accounting matches the costs (expenses) and revenues (based

on those costs). The important point here is that, for utilities, accounting follows ratemaking, not the other way around.

Q. CAN YOU PROVIDE A SIMPLE EXAMPLE OF HOW ASC 980 IS APPLIED?

A. Yes. Assume a major hurricane occurs in 2019 resulting in considerable damage to two entities. One entity is a rate-regulated utility and the other is an unregulated maker of widgets. Both entities spend $20 million performing a variety of storm restoration and maintenance activities to repair the damage caused by the hurricane. Under GAAP, both entities would record $20 million of maintenance expense as a period cost in 2019 as both companies incurred $20 million of maintenance costs in that period.

In this situation, it is likely that the widget maker would not be able to pass along the $20 million maintenance expense in the price of widgets because widget prices are set by the competitive widget market where there is no direct correlation between current costs and future revenues. Thus, absent insurance recoveries, the widget company would likely report lower than expected net income in 2019 due to the additional expense related to the hurricane. (I do note that the opposite is also true in my example; in other words, if the widget maker is able to reduce other costs or is able to pass along the increased cost through higher prices to consumers, then the widget maker could possibly offset a portion or negate completely the impact of the hurricane cost. Thus, as it relates to the widget maker, the net income impact is variable and dependent on a number of factors). The regulated utility company, however, would likely

seek approval of recovery of this cost from its regulator. Precedent would play an important role in determining whether rate actions of the regulator would permit future rate recovery of the storm costs. If the utility concluded that recovery of the $20 million was probable (generally viewed as having a greater than a 75% likelihood of recovery), it would reverse the $20 million of maintenance expense (remove from the 2019 income statement) and record a regulatory asset (add to the 2019 balance sheet). The regulatory asset would then be charged to expense (amortized) in the period(s) that the regulator permitted recovery of the regulatory asset through rates. So, if the regulator permitted recovery of the $20 million storm restoration and maintenance at the rate of $5 million per year for four years beginning in 2020, the utility would amortize $5 million of the regulatory asset each year as amortization expense to match the $5 million of additional revenues it is able to bill customers to recover that cost. In addition, as discussed below, the utility would typically receive a return on the unamortized balance to account for the time value of money and the overall cost of capital.

Q. IN YOUR EXAMPLE, THE UTILITY DOES NOT REPORT AN EXPENSE IN ITS 2019 INCOME STATEMENT LIKE THE WIDGET COMPANY BUT DEFERS THAT COST ON ITS BALANCE SHEET (AS A REGULATORY ASSET), AND SUBSEQUENTLY AMORTIZES THAT COST TO THE INCOME STATEMENT IN THE PERIODS IT IS BEING RECOVERED IN REGULATED RATES. IS THAT BECAUSE OF COST-BASED RATE REGULATION?

A. Yes. SFAS 71 as originally issued noted:

> *"This Statement may require that a cost be accounted for in a different manner from that required by another authoritative pronouncement. In that case, this Statement is to be followed because it reflects the economic effects of the rate-making process—effects not considered in other authoritative pronouncements. All other provisions of that other authoritative pronouncement apply to the regulated enterprise."*

As previously stated, the ratemaking process provides a linkage between costs and revenues, creating an economic effect which is reflected in GAAP financial statements for rate-regulated entities. ASC 980 has been in effect for many years and the concept of regulatory assets and regulatory liabilities is not a new one. If the conditions of ASC 980 are met, regulated entities will recognize a regulatory asset or liability whenever expenses or revenues are recognized in one period for regulated ratemaking but would have been recognized in another period under GAAP for an unregulated entity.

The important point here is that the GAAP accounting for rate-regulated utilities follows the ratemaking process to reflect the unique, economic consequences of rate regulation.

Q. ARE THERE OTHER EXAMPLES YOU CAN CITE ON HOW ASC 980 IS APPLIED?

A. Yes. Utilities with automatic purchased power adjustment clauses defer the difference between the purchased power costs incurred in the period and the purchased power expense being collected through current rates as a regulatory asset or liability so that the purchased power expense shown in the income statement matches the purchased power expense collected through current rates (i.e., revenue equals expense). Purchased power expense in excess of the amount collected through current rates is deferred until the period in which such expense is charged to customers. Again, such difference between the GAAP expense and ratemaking recovery is deferred by regulated entities as a regulatory asset or liability. There are many other similar examples that could be cited.

Q. WHEN UTILITY INVESTORS SUPPLY THE FUNDING FOR EXPENDITURES PRIOR TO RECOVERY FROM CUSTOMERS, IS A RETURN GENERALLY PERMITTED ON SUCH A REGULATORY ASSET UNTIL RECOVERY HAS OCCURRED?

A. Yes. In utility accounting and ratemaking there is a concept of "recovery of" and "return on" investment. Simply stated, recovery of the investment means the investor receives full cost recovery of each dollar invested. This is best illustrated by referring to the investment in Property, Plant and Equipment ("PP&E"). An investment in a generating facility, for example, requires capital investment on the front-end to acquire or construct the facility. The investor

recovers its investment as the plant is depreciated and the customers pay the revenue requirement (which includes recovery of depreciation expense). However, as the investor has supplied the funds for investment in the plant in advance of recovering such investment, it is also entitled to a return on its investment related to the time value of money, opportunity cost and risk associated with its overall investment. Therefore, the undepreciated cost (i.e., remaining net book value) of the plant is included within rate base and earns an allowed return. In this manner, over the asset's life, the investor receives its money back and earns a return on its investment until fully recovered.

The same concept applies to other investor funding where recovery occurs over time. In my hurricane example above, this would result in the regulatory commission permitting a return (sometimes referred to as a "carrying charge") on the initial $20 million provided by the utility investor to restore service until such balance has been recovered through amortization of the regulatory asset. In this manner, the investor is made whole for its investment.

Q. WHAT IF INVESTORS DO NOT RECEIVE BOTH RECOVERY OF AND RETURN ON THEIR INVESTMENTS?

A. If investors do not receive both recovery of and return on their investments, it increases investment risk and, all other things being equal, may increase a company's cost of capital. Capital markets are competitive markets, and, therefore, utilities must attract capital from investors who have investment alternatives. If investor risk and return expectations are not met for a particular investment opportunity, I would expect that investors would take their capital

elsewhere. As capital-intensive industries, such as regulated utilities, require significant capital investment, not permitting an adequate return on investment may impact a company's ability to attract capital. As most utility investment funding is both recovered and receives a return, capital investment that does not recover both is at a competitive disadvantage.

III. DEFERRAL ACCOUNTING

Q. PLEASE EXPLAIN WHAT A DEFERRAL IS AND WHAT IT IS INTENDED TO DO FROM THE UTILITY'S PERSPECTIVE.

A. In the O&M context, a "deferral," as it relates to expenditures of a utility, represents delayed expense recognition (i.e., deferral of expenses on a utility's balance sheet). The purpose of delaying the recognition of the expense is to align recognition of expense with the recovery (via revenue) from the utility's customers. Under the utility compact with regulators, all prudently incurred costs are expected to be recoverable from customers. Rates are set (i.e., a utility's revenue requirement) based on the combination of a utility's revenues, income, and expenses and its allowed return on rate base. To the extent increases in operating expenses occur, absent growth in the customer base, tariff rates by default must increase to allow for the recovery of such incremental cost. The general purpose of a cost deferral is to mitigate the effect of this material, incremental cost on rates by spreading the cost out over a period of time. It can also have the effect of allowing a cost sharing between current and future ratepayers.

In my opinion and based on my experience, deferral mechanisms represent another tool that utilities and commissions are able to use in managing rates as part of the ratemaking process. The starting point for the development of tariff rates is the concept that utilities will recover their current reasonable and necessary operating expenses and earn a return on invested capital. The sum of these components, the utility's cost of service, comprises the utility's revenue requirement. For purposes of setting rates, the cost of service is generally based on either the historical test period for a particular rate case, adjusted on a proforma basis to remove items included in the test period that are not expected to continue in the future or include items in its filing that are expected to occur in the future that were not previously incurred in the historical test period. Alternatively, in certain jurisdictions, a future or prospective test period is permitted. The essence of these approaches is that utilities will recover their current cost of service on a timely basis. If a utility does not recover its current cost of service and its earnings are materially impacted, it is likely that a utility would have to initiate further rate case proceedings in an attempt to rectify the economic shortfall. A deferral mechanism can be requested by a utility or utilized by a regulator as a means of providing the dual benefit of providing a utility the recovery, over a reasonable period of time, of prudently incurred costs, as well as avoiding rate shock to current ratepayers by spreading these costs over a period greater than one year. I do note, however, that the delayed cash recovery of these incurred costs does have a negative effect on a company's credit metrics.

Q. IS THERE AN ACCOUNTING STANDARD THAT ADDRESSES DEFERRALS?

A. Yes. As discussed above, ASC 980 relates directly to the concept of deferrals. ASC 980 specifically allows for the deferral of incurred costs on the balance sheet that would otherwise be charged to expense if such costs are probable of recovery from ratepayers in the future. The term probable in the context of ASC 980 means that management believes, based on all available evidence, that generally there is at least a 75% likelihood that such costs will be recovered from ratepayers in the future. Evidence to support such a determination could come in the form of a formal rate or accounting order from a commission, historical precedent within a jurisdiction, discussion with the commission on such matters, or other evidence. This deferral would then be amortized to expense in the period that such recovery occurs. An example of the accounting journal entries would be helpful with this discussion. All amounts are illustrative entries and do not represent actual amounts recorded. Note that my example assumes all costs were deemed prudently incurred, and that a regulator has allowed (a) recovery of such costs over a five-year period, and (b) a carrying charge on the deferred cost balance (based on my example utilizes weighted average cost of capital of 7%).

Entry #1: Recognize $1,000 of expense for a cost incurred in Year 1:

Debit - Expense	1,000
Credit - Cash	1,000

Entry #2: Defer expense recognition of cost incurred in Year 1 in accordance with ASC 980:

Debit - Regulatory Asset - Cost Deferral	1,000
Credit - Expense	1,000

Entry #3: Record amortization of the regulatory asset in year 1 through 5 to match the tariff revenue charged to ratepayers:

Debit - Amortization Expense	200
Credit - Regulatory Asset – Cost Deferral	200

Entry #4: Recognize the tariff revenue charged to ratepayers:

Debit - Cash	200
Credit - Revenue from Customers	200

Entry #5: Recognize the carrying charge on the uncollected cost deferral. Note that this carrying charge would accrue every year until full recovery; the entry below is the example for year one, and assumes the cash recovery in rates in the year accrued:

Debit - Cash	63
Credit - Revenue – Carrying Charge[2]	63

[2] Simplified carrying charge calculated as follows: average cost deferral in year one of $900 (($1,000 beginning of year + $800 end of year) / 2) multiplied by weighted average cost of capital carrying charge of 7%.

Q. CAN YOU PLEASE EXPLAIN THE CONCEPT OF REGULATORY LAG?

A. Yes. Essentially, the concept of regulatory lag relates to the notion of the timing differences between when costs are incurred by a utility and when such costs are charged to and recovered from ratepayers. If costs of a utility shift, upward or downward, it may be necessary to adjust tariff rates to prevent either an over or under-recovery of costs. If this shift is not addressed on a timely basis, then "lag" occurs, and either a utility does not fully recover its costs or it effectively over-recovers its costs for a period of time. Although regulatory lag is, generally speaking, a natural part of the regulatory process, it is important to mitigate such lag as much as possible, in my opinion, as it increases regulatory risk and therefore increases costs to customers over the long-term because investors (both debt and equity) will demand more to invest in a riskier company.

Q. WHY DOES REGULATORY LAG RESULT IN AN ADVERSE EARNINGS IMPACT?

A. The essence of the regulatory compact is that in return for monopoly status, in conjunction with the attendant obligation to serve, utilities are able to fully recover prudently incurred costs and earn a return on invested capital. To the extent that a utility experiences regulatory lag (and especially if such lag manifests itself over the long-term), this results in an adverse earnings impact in a number of ways. Regulatory lag is the result of rates that differ from the actual costs a utility incurs and its allowed return on actual rate base. To the

extent that a utility's costs go down, then unless tariff rates are reset on a timely basis, a utility would essentially realize earnings greater than prescribed in its previous rate order. This "excess" earnings would be viewed as adverse from a ratepayer perspective. In my experience, more often than not, however, the rate lag experienced by utilities relates to a situation where such utilities' costs and/or rate base have increased, but tariff rates have not been adjusted on a timely basis to account for such growth. A common example of rate lag is where certain plant is placed in service and depreciation of the asset has commenced, but the revenues associated with the recovery of (and on) the asset are not yet built into tariff rates. As a result, earnings of a utility experiencing rate lag associated with cost of service and/or rate base growth are negatively impacted (i.e., the utility in this situation would be under-earning in relation to what was allowed in its previous rate case which increases the riskiness of the investment from an investor standpoint, resulting in a higher cost of capital).

Q. CAN YOU EXPLAIN WHAT THE FINANCIAL IMPACT TO THE COMPANY IS ABSENT A DEFERRAL?

A. Yes. If a utility incurs a type of cost that was not anticipated, or a cost at a level that was not forecasted in its prior rate case, the utility would be required to charge that cost to current expense under GAAP absent the request by a utility and approval of a deferral mechanism by a regulator, or other evidence supporting an assertion that costs are probable of recovery. Under this scenario, it is unlikely that the utility would have the ability to support the deferral of the costs incurred as a regulatory asset on its balance sheet, as the utility would not

have a basis to conclude that such costs are probable of recovery from ratepayers in the future. The end result of this accounting would be a reduction in the utility's earnings (net income) for the period, effectively resulting in a lower return on invested capital.

Q. ARE THERE ANY CUSTOMER BENEFITS THAT RESULT FROM DEFERRALS?

A. Yes. I have stated in my testimony that the basis of the utility regulatory compact is to allow utilities to fully recover prudently incurred costs and earn a fair return on invested capital in return for serving all customers within a jurisdiction. To the extent that a utility incurs a cost of providing service, utilizes its own funds (provided by its investors) to pay for such costs, and recovery of such costs is deferred to the future, customers are essentially receiving an interest-free loan from the utility (absent a carrying charge). Specifically, customers pay for the utility's expenditure over a period of time rather than at the point the utility incurs the expense. This is achieved by not including the full cost in current tariff rates, and instead adding on a portion of such cost to rates each year until the full balance is recovered. Another way to think about this is to consider the deferral as a customer financing (i.e., the ratepayers are obligated to reimburse the utility, and will do so over a period of time).

Q. IS THE ALTERNATIVE TO REQUESTING A DEFERRAL MORE FREQUENT RATE CASES?

A. Yes. If a utility incurs a cost, and this charge is not currently included in current cost of service (and therefore is not being recovered from ratepayers), then management effectively has two alternatives. The first alternative is to request a deferral of such costs (assuming they are significant enough to warrant separate deferral and recovery). Absent the allowance of a deferral mechanism, if a utility believes such costs will continue to be incurred in the future, then the utility has a second alternative which is to request and conduct more frequent rate case proceedings. It is important to note that these decisions are only made after careful analysis of alternatives, as rate case proceedings can be costly and time consuming for the company involved, the commission and other interested parties. As I have discussed throughout my testimony, rates of a utility are intended to be set at a level that allows for the full recovery of the utility's cost of service (current expenses and a reasonable return on rate base). To the extent that a utility incurs costs as part of performing its function as an operating utility, but those costs are not recovered from ratepayers, the result is that the utility will effectively earn less than its allowed return. In my opinion, there are negative consequences of a utility under-earning in relation to its allowed return. Specifically (and assuming equivalent performance levels), I would expect an investor to view a utility in this situation to represent an investment reflecting greater investment risk (due to its inability to fully recovery prudently incurred costs) than a utility that is earning its full return. This view would then

drive an investor to expect a higher return (for equity investors) or yields (for debt investors) to compensate the investor for the heightened risk, resulting in an increase to the utility's cost of capital (and therefore cost to ratepayers). It is my understanding from Company personnel that DEC is entering a highly capital-intensive phase of its business, which will last at least a decade. If that is the case, it is critical for the investors to perceive the Company as having low investment risk to ensure the Company continues to have access to low-cost capital to fund its operations, while at the same time mitigating the impact of rate increases to customers.

Q. CAN YOU EXPLAIN HOW DEFERRALS WORK IN THE REGULATED CONTEXT?

A. Over my career, I have encountered numerous types of deferral applications and requests to bring deferred costs into rates. Although the specific types and nature of deferrals can vary with each jurisdiction across the United States, the underlying regulatory concepts are similar. The regulatory compact between utilities and regulators allows for utilities to operate as a monopoly within a specific jurisdiction in return for accepting responsibility to provide service to the citizens in that particular jurisdiction. The utility is subject to the oversight of the regulatory commission responsible for that jurisdiction. A key element of this regulatory compact is that the commission will set rates at a level to allow the utility to recover prudently incurred costs and earn a reasonable return on invested capital (rate base). At times, utilities incur costs that, although deemed to have been prudently incurred, a regulator or a utility may decide to

not immediately include in rates. Reasons for delaying immediate recovery of these costs can include the desire to avoid "rate shock," and sharing of such costs between current and future ratepayers. It is important to note here that although such cost deferrals are not the equivalent of invested capital, in my experience they are treated in a similar manner for ratemaking purposes. Specifically, it is important that cost deferrals receive a carrying charge (similar to that provided on a utility's rate base) to compensate a utility investor for the use of capital. In the situation where a utility has expended funds to pay for reasonable and prudently incurred costs, it is important to provide the utility investor with a return (i.e., a carrying charge) on their investment until such cost is recovered in the ratemaking process. Otherwise, a utility would not be fully recovering its true cost of capital, and the delayed cost recovery would cause an investor to view the utility as having greater regulatory risk than a utility that does recover its total cost of capital.

Q. ARE YOU FAMILIAR WITH DEFERRAL APPLICATIONS AND HOW THEY ARE PRESENTED TO REGULATORY COMMISSIONS FOR APPROVAL?

A. Yes. Consistent with my discussion in relation to the previous question and response, deferral applications are generally presented to commissions based on a number of factors, including historical precedent, recommendations of various parties involved in a particular application, goals of the commission, potential impact of the application on tariff rates, and other factors. The application would include a discussion of nature of costs incurred, historical

treatment of such costs, and requested treatment from a regulatory and accounting perspective.

Q. ONCE THAT APPROVAL IS GRANTED, HOW ARE DEFERRED COSTS ULTIMATELY RECOVERED BY THE UTILITY?

A. If a deferral is granted, or ordered, this is an indication that such costs are recoverable in the future; however, ultimate recovery will be dependent on the final order issued in a future rate proceeding. In particular, ultimate recovery of costs is dependent on a final review of the prudency of such costs in a future proceeding. Once an approval of a deferral application is granted, when the utility comes in for its next general rate case, it will typically seek to recover the deferred costs in its rates. The utility will propose, and the commission will ultimately decide, the period over which such costs will be recovered from ratepayers. This period becomes the timeframe over which such deferred costs are amortized (as amortization expense) and recovered from ratepayers. The annual amortization expense is included in the cost of service, offset by the recognition/recovery of revenue, allowing for the matching of revenue and expense. The only item impacting net income in this situation would be the recognition of a carrying charge (the equity component) on unrecovered deferred costs.

Q. PLEASE EXPLAIN THE ACCOUNTING AND REGULATORY TREATMENT OF CAPITAL COSTS VERSUS OPERATION AND MAINTENANCE EXPENSES UNDER NORMAL RATEMAKING CIRCUMSTANCES.

A. From an accounting perspective, if costs are capital in nature, then these costs are capitalized as part of PP&E under GAAP. Assuming such costs were prudently incurred and both "used and useful" for the customers of the utility, then the PP&E balances would be depreciated over their estimated useful lives, with this depreciation expense recovered as a component of the tariff charge collected from customers. In addition, the unrecovered (i.e., remaining net book value) plant balance would represent a component of rate base and the utility would earn its allowed return on this invested capital.

O&M expense is different from the capital cost accounting and regulatory treatment discussed above in that O&M is normally incurred (immediately charged to the income statement) and recovered from ratepayers on a current (i.e., short-term; in general, one year or less) basis. A utility would expect to recover its incurred costs such as O&M on a timely basis and therefore would expect the recovery of the expense (similar to the depreciation recovery discussed above). However, unlike capital costs, under normal ratemaking circumstances, the utility would not have an expectation of receiving a return in relation to O&M costs incurred. This, again, is due to the timing of the recovery of the expense (i.e., the utility would expect to recover O&M expenditures on a timely (short-term) basis) from ratepayers.

Q. BY CONTRAST, WHAT IS THE APPROPRIATE ACCOUNTING AND REGULATORY TREATMENT FOR DEFERRED O&M EXPENSE?

A. As I described in the previous two paragraphs, there is a basic difference in the accounting and regulatory treatment of capital versus O&M expenses under normal ratemaking circumstances. However, it is important to recognize that if the timing of the recovery of O&M expenses were to change from a short-term period to long-term period, as it would in the case of deferred expenses amortized over period greater than one year, then the accounting and regulatory treatment for O&M expense should align with the methodology used for capital expenditures. In this case, assuming that the "probability of future recovery" test has been met through, for example, receipt of an order by a commission allowing for recovery of incurred costs in the future, the expenses would be deferred on the balance sheet as a regulatory asset pursuant to the accounting guidance set forth in ASC 980. This regulatory asset would then be amortized to expense over the period of recovery from ratepayers. Importantly, because the utility had actual cash outlays raised from debt and equity investors associated with the O&M costs that are now being deferred, the investors would expect to receive a return and therefore, the utility would expect to recover its carrying costs on the unamortized balance.

Q. IS IT TYPICAL IN OTHER STATES FOR A UTILITY TO RECOVER ITS CARRYING COSTS ON DEFERRED O&M COSTS?

A. Yes. It is important to differentiate between deferred costs for which there has been a cash outlay versus cost deferrals associated with non-cash expenses.

More specifically, there are certain costs that a utility might incur that must be recognized as expenses under GAAP for which there are no cash outlays. Examples of these types of expenses include items such as net periodic pension expense, amortization expenses associated with asset retirement obligation costs, and unrealized losses on derivatives. Separately, there are other types of expenses for which a utility would have associated cash outlays. Recurring O&M costs, storm costs and realized losses on derivatives would be representative examples of cash expenses. If a regulator does allow for a utility to defer costs for recovery in the future, and if such costs are related to items for which the utility had associated cash outlays, then, generally speaking, I would expect that such unrecovered balances would receive a return to compensate the utility for the use of its cash.

It is also important to note that the logic associated with this regulatory treatment is consistent with a situation where a utility has received customer funds in advance of expenditures. A good example of this, applied consistently across the United States, is in connection with Cost of Removal accounting. Utilities generally recover, through an increase in depreciation expense, the estimated cost of removal it expects to incur well into the future upon retiring/removing the fixed asset from service at the end of the depreciable life. This method is appropriate as it is current customers who are benefitting from the use of the particular fixed asset and these customers should be charged for not only the use of the fixed asset (through depreciation) but the ultimate cost of removal. As a result, cost of removal funds received from customers

throughout the life of the fixed asset in advance of actual removal activities are recorded as regulatory liabilities by utilities, with the outstanding balance being net against a company's rate base; the effect of this is to reduce the cost of capital recovery by taking into account the advance cash funding by customers for removal activities.

In situations whereby a utility has incurred costs in a prudent manner in advance of recovery from ratepayers in the future, such cost deferral is the equivalent of utility investment activity. My point here is to highlight that the utility's activity is being performed on behalf of the customer, and that prudent cash expenditures should be recovered from ratepayers. To the extent that such recovery is deferred, for example to avoid rate shock or for other purposes, then the utility's capital has been deployed. As previously stated, if investors do not receive both recovery of and return on capital deployed, it increases investment risk and, all other things being equal, may increase a company's cost of capital. Thus, deployed capital that does not recover both a recovery of and return on capital is at a competitive disadvantage.

Q. IN YOUR EXPERT OPINION, IS IT APPROPRIATE TO RECOVER A RETURN ON ALL DEFERRED COSTS REGARDLESS OF WHETHER THEY ARE CAPITAL IN NATURE?

A. Yes. The concepts of ratemaking start with the premise that a utility is entitled to recover prudently incurred costs (expense), as well as earn a fair return on its investments (rate base). Underlying this premise is the notion that ratepayers will pay, on a timely basis, for cash expenses as well as the cost of capital on

unrecovered investments. In my opinion, in situations whereby a utility has incurred costs in a prudent manner, and a regulator determines based on current facts and circumstances to allow for the recovery over time (rather than immediate recovery) of such expenses, such cost deferral should receive rate treatment equivalent to utility investment activity. Current cost of service operating expenses as well as investment activity, assuming such activity was prudently incurred, is all performed in the best interest of ratepayers. The primary difference between operating expenses and investments, in my opinion, relates to who the direct beneficiaries are of such activities. Again, the concept of "matching revenues with expenses" comes into play; operating expenses are recovered, in general, in the short-term as current ratepayers benefit from such activities. On the other hand, investment activity is recovered over the long-term, as ratepayers (current and future) benefit from such investments over the life of the investment. When a regulator makes the determination to defer cost recovery of actual cash expenditures, the commission is lengthening the recovery period and essentially spreading the cost between existing and future ratepayers. As such, it is appropriate, in my view, to allow for a carrying charge on deferred costs regardless of whether they are capital in nature.

Q. DO YOU BELIEVE THAT THE COMPANY SHOULD BE PERMITTED TO RECOVER FINANCING COSTS ASSOCIATED WITH THE DEFERRED COSTS IT SEEKS TO BRING INTO RATES IN THIS CASE?

A. Yes. In my opinion, if a utility incurs an expense for which there is a related cash outlay (regardless of whether the expense is capital or operating in nature), then to the extent that there is delayed recovery of such expense, it is important to make the utility whole for the use of its capital. That being said, I do note that it is typical for utilities to only receive (or pay) a carrying charge for long-term deferrals (i.e., periods greater than one year). As it is my understanding that the Company has proposed amortization periods longer than one year for all the deferred costs for which it seeks recovery in this case, a return of and on these costs should be allowed for the reasons set forth in my testimony.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.